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No. 87-1020

IN THE SUPREME COURT
OF THE UNITED STATES

October Term, 1988

PAUL S. DAVIS,

Appellant,

v.

STATE OF MICHIGAN,
DEPARTMENT OF TREASURY,

Appellees.

On Appeal From the
Michigan Court of Appeals

BRIEF FOR APPELLEES

FRANK J. KELLEY
ATTORNEY GENERAL

LOUIS J. CARUSO
Solicitor General
Counsel of Record
760 Law Building
525 West Ottawa Street
Lansing, MI 48913

Thomas L. Casey
Assistant Solicitor General
Richard R. Roesch
Ross H. Bishop
Assistant Attorneys General
Attorneys for Appellees

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QUESTION PRESENTED

Does the Michigan Income Tax Act, which provides a complete exemption for income from Michigan Public Retirement Systems but provides only a partial exemption for most federal retirement benefits, violate 4 USC § 111?

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4 USC § 111:

> The United States consents to the taxation of pay or compensation for personal service as an officer or employee of the United States, a territory or possession or political subdivision thereof, the government of the District of Columbia, or an agency or instrumentality of one or more of the foregoing, by a duly constituted taxing authority having jurisdiction, if the taxation does not discriminate against the officer or employee because of the source of the pay or compensation.

5 USC § 2105:

> (a) For the purpose of this title, "employee," except as otherwise provided by this section or when specifically modified, means an officer and an individual who is -- (1) appointed in the civil service by one of the following acting in an official capacity.
>
> (A) the President;
>
> (B) a Member or Members of Congress, or the Congress;
>
> (C) a member of a uniformed service;
>
> (D) an individual who is an employee under this section;

(E) the head of a Government controlled corporation; or

(F) the adjutant general designated by the Secretary concerned under section 709(c) of title 32;

(2) engaged in the performance of Federal function under authority of law or an Executive act; and

(3) subject to the supervision of an individual named by paragraph (1) of this subsection while engaged in the performance of the duties of his position.

***

5 USC § 8331(1)(A):
[Civil Service Retirement]

> For the purposes of this subsection "employee" means an employee as defined by section 2105 of this title;

5 USC § 8331(9):
[Civil Service Retirement]

> For the purposes of this subsection "annuitant" means a former employee or Member who, on the basis of his service, meets all requirements of this subchapter for title to an annuity and files claim therefor.

26 USC § 3401(c):
[Internal Revenue Code]

> For purposes of this chapter, the term "employee" includes an officer, employee or elected official of the United States, a State, or any political subdivision thereof, or the District of Columbia, or any agency or instrumentality of any one or more of the foregoing. The term "employee" also includes an officer of a corporation.

Michigan

MCL 206.8(2):
[Income Tax Act]

> "Employee" means an employee as defined in section 3401(c) of the internal revenue code. Any person from whom an employer is required to withhold for federal income tax purposes shall prima facie be deemed an employee.

MCL 206.30(1)(g), (h):
[Income Tax Act]

> "Taxable income" in the case of a person other than a corporation, an estate, or trust means adjusted gross income as defined in the internal revenue code subject to the following adjustments:
>
> ***
>
> (g) Deduct, to the extent included in federal adjusted gross income, compensation, including retirement benefits, received for services in the armed forces of the United States.

(h) Deduct, to the extent included in adjusted gross income:

(i) Retirement or pension benefits received from a public retirement system of or created by an act of this state or a political subdivision of this state.

(ii) Any retirement or pension benefits received from a public retirement system of or created by another state or any of its political subdivisions if the income tax laws of the other state permit a similar deduction or exemption or a reciprocal deduction or exemption of a retirement or pension benefit received from a public retirement system of or created by this state or any of the political subdivisions of this state.

(iii) Social security benefits as defined in section 86 of the internal revenue code.

(iv) Retirement or pension benefits from any other retirement or pension system as follows:

(A) For a single return, the sum of not more than $7,500.00.

(B) For a joint return, the sum of not more than $10,000.00.

[NOTE: In 1987 Public Act 254 this Act was amended and this subsection was redesignated with no change in substance. For convenience we will use the designations as they have been referred to throughout this litigation.]

Michigan Administrative Code of 1979, Rule 206.2:

(1) The term "employee" is defined in section 8(2) of Act No. 281 of the Public Acts of 1967, as amended, being § 206.8(2) of the Michigan Compiled Laws.

(2) The term "employee" includes every individual performing services if the relationship between him and the person for whom he performs such services is the legal relationship of employer and employee. The term includes officers and employees, whether elected or appointed, of the United States, a state, territory, Puerto Rico, or any political subdivision thereof, or the District of Columbia, or any agency or instrumentality of any 1 or more of the foregoing.

(3) Generally, the relationship of employer and employee exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work, but also as to the details and means by which that result is accomplished; that is, an employee is subject to the will and control of the employer, not only as to what shall be done, but also as to how it shall be done. However, it is not necessary that the employer actually direct or control the manner in which the services are performed; it is sufficient if he has the right to do so. The right to discharge is also

an important factor indicating that the person possessing that right is an employer. Other factors characteristic of an employer, but not necessarily present in every case, are the furnishing of tools and the furnishing of a place to work to the individual who performs the services. In general, if an individual is subject to the control or direction of another merely as to the result to be accomplished by the work but not as to the means and methods for accomplishing the result, he is not an employee.

(4) Generally, physicians, lawyers, dentists, veterinarians, contractors, subcontractors, public stenographers, auctioneers, and others who follow an independent trade, business, or profession, in which they offer their services to the public, are not employees.

(5) Whether the relationship of employer and employee exists shall, in doubtful cases, be determined upon an examination of the particular facts of each case.

(6) If the relationship of employer and employee exists, the designation or description of the relationship by the parties as anything other than that of employer and employee is immaterial. For example, it is of no consequence that the employee is designated as a partner, coadventurer, agent, independent contractor, or the like.

(7) All classes or grades of employees are included within the relationship of employer and employee. Thus, superintendents, managers, and other supervisory personnel are employees. Generally, an officer of a corporation is an employee of the corporation. However, an officer of a corporation who as such does not perform any services, or performs only minor services, and who neither receives nor is entitled to receive, directly or indirectly, any remuneration, is not considered to be an employee of the corporation. A director of a corporation in his capacity as a director is not an employee of the corporation.

(8) The term "employee" includes every individual who receives a supplemental unemployment compensation benefit, which is treated as wages.

STATEMENT OF THE CASE

Appellee State of Michigan accepts the statement of the case contained in the briefs of Appellant Davis and Amicus Curiae United States.

SUMMARY OF ARGUMENT

The Michigan Income Tax Act provides a complete exemption for Michigan Public Retirement benefits, but only a partial exemption for other retirement benefits, including federal retirement benefits. In 4 USC § 111 the United States consents to taxation for compensation of federal employees, if the taxation does not discriminate against the employees because of the source of the compensation. The Michigan Income Tax Act does not violate 4 USC § 111 because Appellant Davis is a retiree, not an employee; because the discrimination which the

statute prohibits is discrimination against the government, not individuals; and because any discrimination which occurs is permissible because substantial differences exist between federal and state retirement benefits and the Michigan statutes are rationally related to the legitimate public purpose of fostering Michigan public employment.

The legislative history of 4 USC § 111 shows that Congress intended to permit federal employees to assert only those constitutional and statutory rights to which they, as individuals, were entitled. Congress did not intend that individuals could assert rights under the constitutional doctrine of intergovernmental tax immunity. 4 USC § 111 protects only the government itself under that constitutional doctrine and only to

the extent that state taxation is aimed at, or threatens the efficient operation of, the government itself. There is nothing in the record of this case to show that the Michigan Income Tax Act is aimed at the federal government, threatens the efficient operation of the federal government or, indeed, has any detrimental impact of any kind on the federal government.

The constitutional doctrine of intergovernmental tax immunity, as explained in Graves v New York, ex rel O'Keefe, 306 US 466 (1939), and other cases, is based on the Supremacy Clause and protects only governments--not individuals--from taxation efforts of other governments. Even though a government employee suffers adverse effects and some burdens are passed on to

the government itself, it cannot be assumed that the constitutional doctrine is violated, since some burdens are too speculative and other burdens are presupposed by the Constitution as the normal incidence of intergovernmental relations. The constitutional doctrine is violated only when the actual burdens are so severe as to be tantamount to an interference in the performance of governmental functions. There is nothing in the record of this case to show that the Michigan income tax imposes that type of burden on the federal government.

If the Court should conclude that the Michigan Income Tax Act violates federal rights, the appropriate remedy would be to award Appellant Davis the refund he seeks and then vacate the Michigan Court of Appeals judgment and remand to the

state courts with a mandate of equal treatment. The Michigan courts or the Michigan legislature could then determine whether to expand the tax exemption to those whose rights were violated by underinclusion or to nullify the exemption for those who currently enjoy it. Alternatively, if this Court imposes a remedy, it should extend the exemption rather than nullify it.

ARGUMENT

I

THE MICHIGAN INCOME TAX ACT WHICH PROVIDES A COMPLETE EXEMPTION FOR INCOME FROM MICHIGAN PUBLIC RETIREMENT SYSTEMS BUT PROVIDES ONLY A PARTIAL EXEMPTION FOR MOST FEDERAL RETIREMENT BENEFITS DOES NOT VIOLATE 4 USC § 111.

A. The Constitutional Doctrine Of Intergovernmental Tax Immunity May Not Be Asserted By An Individual Federal Employee Or Retiree To Challenge A State Income Tax.

1. The Arguments Of Appellant Davis And The Amici Curiae Improperly Attempt To Intermix The Statutory Interpretation Of 4 USC § 111 And The Principles Of The Constitutional Doctrine Of Intergovernmental Tax Immunity.

Much of the argument of Appellant Davis and both amici curiae concerns the doctrine of intergovernmental tax immunity. This doctrine, which is based on the Supremacy Clause, was first enunciated in McCulloch v Maryland, 4 Wheat 316 (1819), and has been discussed

and modified in many later cases including most recently South Carolina v Baker, 485 US ___, 99 L Ed 2d 592 (1988), which contains a summary of the history of the doctrine. Appellee State of Michigan asserts that the constitutional doctrine is irrelevant here because Graves v New York, ex rel O'Keefe, 306 US 466 (1939), holds that the doctrine is inapplicable to an income tax imposed by a state on federal employees and retirees and because the congressional history of 4 USC § 111 shows that Congress did not intend to codify the entire pre-existing constitutional doctrine, but only provided statutory protection for the federal government itself, not for employees.

Appellant Davis relies principally upon a statutory interpretation argument,

but in the course of doing so, attempts to use principles of the constitutional doctrine. The United States as amicus curiae asserts that the statute "restates ... the general constitutional rule" (brief, p 7) and although never categorically asserting that 4 USC § 111 must be interpreted the same as the constitutional doctrine, somewhat disingenuously says that "If construed the same way as the nondiscrimination principle derived from the doctrine of intergovernmental tax immunity, § 111 precludes" the Michigan statutory system here at issue (brief, p 6, emphasis added). The amicus curiae National Association of Retired Federal Employees (NARFE) recognizes a clear distinction between the interpretation of the statute and the constitutional doctrine, but

while relying principally on a statutory interpretation argument, completely ignores both the existence and ramifications of Graves in its constitutional argument. Appellee State of Michigan submits that Appellant Davis and both of the amici curiae fail to fully acknowledge the holding in Graves and give far too broad an interpretation to 4 USC § 111.

2. Graves v New York, ex rel O'Keefe Holds That The Constitutional Doctrine Of Intergovernmental Tax Immunity Cannot Be Asserted By An Individual Federal Employee Or Retiree To Challenge A State Income Tax.

In Graves, supra, this Court examined the constitutionality of an income tax imposed by the State of New York on the salary of an attorney employed by a federal instrumentality and concluded that such an income tax did not place an

unconstitutional burden on the federal government. In reaching that conclusion the Court discussed the principles underlying the doctrine of intergovernmental tax immunity and concluded that the only legitimate purpose of the doctrine was to protect the unique governmental functions of both the state and federal governments, 306 US at 477-478:

> "The theory of the tax immunity of either government, state or national, and its instrumentalities, from taxation by the other, has been rested upon an implied limitation on the taxing power of each, such as to forestall undue interference, through the exercise of that power, with the governmental activities of the other."

The Court observed that the constitutional doctrine of intergovernmental tax immunity must be "narrowly restricted", particularly where that immunity is

invoked by a private citizen, Graves, supra, 306 US at 483-484:

> " ... as applied to the taxation of salaries of the employees of one government, the purpose of the immunity was not to confer benefits on the employees by relieving them from contributing their share of the finahcial support of the other government, whose benefits they enjoy, or to give an advantage to that government by enabling it to engage employees at salaries lower than those paid for like services by other employers, public or private, but to prevent undue interference with the one government by imposing on it the tax burdens of the other." [Footnote omitted]

The Court emphasized that the constitutional doctrine protected the governments as entities, not the employees, 306 US at 480-481:

> "The theory, which once won a qualified approval, that a tax on income is legally or economically a tax on its source, is no longer tenable, [citations omitted] and the only possible basis for implying a constitutional immunity from state income tax of the salary of an employee of the national government or of a governmental agency is that the economic burden of the tax is in

> some way passed on so as to impose a burden on the national government tantamount to an interference by one government with the other in the performance of its functions."

In Graves, supra, an argument was made that the economic burden of an income tax on the employee did in fact fall on the employer, but the court rejected this contention as "speculative in character and measurement and too unsubstantial to form the basis of an implied constitutional immunity from taxation." 306 US at 485. The Court discussed an earlier opinion, Helvering v Gerhardt, 304 US 405 (1938), which upheld a federal income tax on the employees of a state agency, and concluded that the tax was not a burden on the agency itself. The Graves court applied the principles of Gerhardt and categorically rejected the argument that an income tax

on an employee can be assumed to impose a burden on the governmental employer. The Court even observed that even though a tax upon the income of employees of a government may result in some burden being passed on to the governmental employer through effects on the price levels of labor or materials, the constitutional doctrine is not necessarily implicated, Graves, supra, 306 US at 487:

> "[That burden] is but the normal incident of the organization within the same territory of two governments, each possessing the taxing power. The burden, so far as it can be said to exist or to affect the government in any indirect or incidental way, is one which the constitution presupposes ... ."

The Court refused to permit the employee taxpayer to assert the governmental employer's constitutional immunity, 306 US at 486:

> "In no case is there basis for the assumption that any such tangible or certain economic benefit is imposed

> on the government concerned as would justify a court's declaring that the taxpayer is clothed with the implied constitutional tax immunity of the government by which he is employed."

In conclusion, the Court rejected earlier cases which permitted governmental employees to assert the constitutional doctrine of intergovernmental tax immunity and overruled them, " ... so far as they recognize an implied constitutional immunity from income taxation of the salaries of officers or employees of the national or a state government or their instrumentalities." Graves, supra, 306 US at 486.

It should be noted that on pages 1-2 of its brief, amicus curiae United States asserts that the Michigan taxation system harms the United States in two ways, but these are precisely the type of arguments which were rejected in Graves as being

too speculative and unsubstantial to permit a federal employee to assert constitutional immunity from taxation. The United States asserts that it is put to a competitive disadvantage in hiring qualified employees because pension benefits of federal retirees would have to be raised in order to attract qualified employees if pension benefits were taxed by Michigan. It also contends that the state's tax scheme forces the United States to subsidize the pension of state retirees through a lower federal tax. Appellee State of Michigan submits that these assertions are not only speculative and unsubstantial, but also wrong.

Pensions of federal retirees are set by statute, 5 USC § 8331 et seq, and as argued infra, pages 51-57, they are more

generous than analogous Michigan benefits. There has been no evidence presented that would indicate that Congress would choose to alter the present federal retirement payments because those payments in excess of $7,500 per year are subject to Michigan income tax. The United States asserts that it loses tax receipts because if the retirement benefits of former state employees were taxed as the benefits of former federal employees are, the State of Michigan would increase state pensions to offset that tax, thus increasing federal tax revenues. This argument is speculative because there is no assurance that Michigan would increase pensions even if they were subject to state tax, and it is wrong because it fails to recognize that state income tax would be claimed as an

itemized deduction, thus lowering federal tax revenues.

These speculative arguments by the United States are insufficient to permit application of the constitutional doctrine of intergovernmental tax immunity to an individual taxpayer such as Appellant Davis.

3. Other Cases Which Define The Modern Doctrine Of Intergovernmental Tax Immunity Do Not Permit An Individual Federal Employee Or Retiree To Assert The Doctrine To Challenge A State Income Tax On The Ground That It Discriminates Against The Individual.

Graves, supra, enunciated the constitutional theory upon which the modern doctrine of intergovernmental tax immunity is based. The fundamental principle is that the doctrine protects only governments, not individuals. The doctrine does not protect governments

against all burdens, since there are many negative effects which are "but the normal incidents" "which the constitution presupposes", 306 US at 487, but it protects governments only against those burdens which are "tantamount to an interference by one government with the other in the performance of its functions.", 306 US at 481. Furthermore, the existence of such an impermissible burden must be demonstrated; it cannot merely be assumed to exist. As is demonstrated elsewhere in this brief (infra, pages 25-57) Appellees submit that the congressional history of 4 USC § 111 shows that congressional intent was fully consistent with these principles enunciated in Graves.

Appellant Davis and the amici cite several cases including Phillips Chemical

Co v Dumas Independent School District, 361 US 376 (1960), Moses Lake Homes v Grant County, 365 US 744 (1961), and Memphis Bank & Trust Co v Garner, 459 US 392 (1983), for the principle that any discrimination by a state statute against a federal employee or retiree triggers the constitutional doctrine of inter-governmental tax immunity and renders the state statute invalid. Appellee State of Michigan submits, however, that those cases do not support such an expansive interpretation of the constitutional doctrine and do not compel the result which Appellant Davis seeks.

Initially it must be observed that those cases are factually distinguishable from the instant situation because, unlike the instant case, they involve commercial or economic relationships

between the federal government and third parties rather than an employer-employee relationship and the application of a state income tax, which was precisely the situation which existed in Graves, supra. Furthermore, in the instant case there is absolutely nothing in the record to demonstrate that the federal government suffers any economic burden or any effects whatsoever from the alleged discrimination while in Phillips and Moses Lake the court specifically concluded that the state practices discriminated against the United States and its lessees. Phillips, supra, 361 US at 387; Moses Lake Homes, supra, 365 US at 751. Memphis Bank & Trust Co also concluded that the economic incidence of a state tax fell on the federal government and that the state tax discriminated

against federal obligations. 459 US at 397.

More important than any factually distinguishing characteristics, however, is the proper application of the constitutional principle of intergovernmental tax immunity. Appellant Davis cites those cases for the proposition that the constitutional doctrine prohibits any discrimination "against the United States or those with whom it deals". Appellant's brief, page 26. Appellee State of Michigan submits that while there is broad language to that effect in the opinions, it must be applied with caution in the instant case for at least two reasons.

First, the language cannot be applied literally since the pragmatic consequences of such an interpretation would

be intolerable. The modern constitutional doctrine requires examination of all of the circumstances surrounding tax statutes alleged to be unconstitutional as the Court said in United States v Detroit, 355 US 466, 469 (1958):

> "Of course in determining whether a tax is actually laid on the United States or its property this Court goes beyond the bare face of the taxing statute to consider all relevant circumstances."

Similarly in Phillips Chemical Co, supra, 361 US at 383, the Court recognized that individual tax statutes do not "operate in a vacuum" and a determination of their constitutionality requires "an examination of the whole tax structure of the state." In this era of extensive economic contacts between governments and private individuals and enterprises, the number of entities "with whom [the government]

deals" is vast indeed. Although Appellant Davis does not argue that a retiree from General Motors, for example, is entitled to assert the constitutional doctrine of intergovernmental tax immunity, can it be doubted that such a retiree would soon make that argument if the doctrine is given the broad scope asserted in the instant case?

The second reason why the doctrine should not be given such a broad scope is related to these pragmatic considerations: the rationale of Graves would surely be violated by such an expansive application of the doctrine. The thrust of the evolution of the modern doctrine, as described in South Carolina v Baker, supra, 485 US ___, shows a clear trend toward a recognition of legal and economic realities. Appellee State of

Michigan submits that a doctrine based on the Supremacy Clause and the principle of protecting only governments in the performance of their governmental functions cannot be invoked by every individual with whom a government deals.

In summary, there is nothing in this record to demonstrate that the federal government suffers any economic burden or any detrimental impact from the alleged discrimination caused by the Michigan Income Tax Act. Under the principles espoused in Graves, it can only be concluded that an individual such as Appellant Davis cannot invoke the doctrine for his own benefit in these circumstances.

B. The Legislative History Of 4 USC § 111 Does Not Indicate That Congress Intended To Codify The Entire Pre-existing Constitutional Doctrine Of Intergovernmental Tax Immunity.

If the constitutional doctrine does not apply, then the issue in the instant case becomes merely one of statutory interpretation. Before making such a statutory interpretation analysis, however, it must be determined whether 4 USC § 111 codifies the constitutional principle, since if it does, the statutory interpretation analysis will be governed by the constitutional principles. See Memphis Bank & Trust Co v Garner, 459 US 392, 396-397 (1983), where the Court interpreted 31 USC § 742 to determine whether a tax was "nondiscriminatory", but the analysis was governed by the principles of the constitutional doctrine of intergovernmental

tax immunity since previous decisions of the Court had treated that statute as "principally a restatement of the constitutional rule." In the instant case Appellee State of Michigan submits that the legislative history indicates that 4 USC § 111 was not intended to codify the constitutional doctrine with respect to individuals such as Appellant Davis and therefore the principles applicable to the constitutional doctrine do not govern the statutory analysis.

Because the principles governing the taxation of governmental employees were undergoing a judicial and congressional upheaval in the late 1930s, it is important to recall the chronology of events of that time. The doctrine of intergovernmental immunity was first recognized in McCulloch v Maryland,

supra, and is not explicitly stated directly in the constitution but is based upon the Supremacy Clause. For decades the doctrine was broadly construed to provide, among other things, that it was unconstitutional for the federal government to impose an income tax on a state employee and for a state government to impose an income tax on a federal employee. The history of the doctrine is summarized in South Carolina v Baker, 99 L Ed 2d at 604-610, and the court stated the rationale for this broad interpretation during the early years of the doctrine, South Carolina v Baker, supra, 99 L Ed 2d at 606:

> "This general rule was based on the rationale that any tax on income a party received under a contract with the government was a tax on the contract and thus a tax 'on' the government because it burdened the government's power to enter into the contract."

In later years, however, this theory was rejected, South Carolina v Baker, supra, 99 L Ed at 607-608:

> "The rationale underlying Pollock and the general immunity for government contract income has been thoroughly repudiated by modern intergovernmental immunity caselaw."

This modern theory is exemplified by Graves v New York, ex rel O'Keefe, supra.

As this change was evolving in a series of cases throughout the 1930s, there were parallel stirrings in the executive and legislative branches of government. For example, Helvering v Gerhardt, supra, 304 US 405, was argued on April 7 and 8, 1938 and decided May 23, 1938. In that short interim period, President Roosevelt sent a message to Congress dated April 25, 1938, emphasizing the need for legislation relating to the taxation of the compen-

sation of public officers and employees. A similar message was sent from the President to the Congress dated January 19, 1939, which, as reported in the Senate's report from the Committee on Finance on the Public Salary Tax Act of 1939, S. Rep. 112, 76th Cong., 1st Sess. (1939), emphasized the need for the legislation, pointed out the equity involved in subjecting the future salaries of government employees to the income tax laws of the nation and of the several states, and "drew attention to the requirement of immediate legislation to prevent recent judicial decisions from operating in such a retroactive fashion as to impose tax liability for past years ... ." That Senate report was issued February 24, 1939, and closely followed the House of Representatives report from

the Committee on Ways and Means, H. R. Rep. 26, 76th Cong., 1st Sess. (1939), dated February 7, 1939. In March, 1939, the month after the congressional reports were issued, the Graves case was argued and decided by this Court, and the Public Salary Tax Act of 1939, chapter 59, 53 Stat. 575, was passed by Congress and became law the next month, April, 1939.

At the time these congressional committee reports were issued, Graves had not yet been decided, and so Congress was operating under the assumption that, while the contours of the doctrine were in flux, the implied constitutional basis of the doctrine required the consent of the United States before the compensation of federal officers and employees could be taxed by the states. The House report said, at page 2:

> "Your committee believes that it is essential to a fair solution of the problem presented by intergovernmental tax immunities that Federal officers and employees should, like other individuals, be subject to income taxation under the authority of the States."

The Senate report was even more explicit in its recognition that, while there might be constitutional problems involved in the proposal to include state salaries in a federal income tax, "there is no corresponding problem with respect to the state taxation of the salaries paid to federal officers and employees, since congress apparently has power to waive any immunity which might attach to its employees." Senate report, supra, page 4. The Senate report goes into considerable detail in its discussion of the cases which were resulting in the evolution of the modern doctrine of

intergovernmental tax immunity, and even quoted from Gerhardt, supra. See Senate report, supra, page 9. Even the amicus curiae brief of the United States recognizes that this statutory section, "was designed to waive federal immunity to permit such taxation." (Brief of the United States as amicus curiae, page 8).

Because of its citation of the principles enunciated in cases such as Gerhardt, supra, and because of the explicit statements that the bill was intended to waive any constitutional immunity from state taxation, it is beyond doubt that, at least with respect to income taxation of individuals, 4 USC § 111 is not a codification of the constitutional principle of intergovernmental tax immunity.

It must be borne in mind, however,

that § 111 contains two aspects; the first portion of the statute contains a consent by the United States to taxation of compensation of federal officers and employees, and the latter portion of the statute contains an exception which withholds consent if the taxation discriminates against the officer or employee because of the source of the compensation. The legislative history shows an express waiver of any constitutional intergovernmental tax immunity which might have been asserted by individual employees while preserving their right to raise other individual objections, but also indicates that Congress did intend to preserve, in the latter part of the statute, the constitutional intergovernmental tax immunity of the United States itself. The congressional

intent with respect to the general grant of consent to taxation of individuals while retaining a limited exception protecting the government is contained in both the House report, supra, pages 4-5, and the Senate report, pages 11-12:

> "In order to facilitate reciprocal taxation as between State and Federal Governments, your committee believes that the United States should expressly consent to the taxation of the compensation of its officers and employees. * * *
>
> "The consent is not intended to operate, nor could it operate, as a consent to any taxation to which as individuals these officers and employees are entitled to object either under the provisions of the Federal Constitution or of the constitutions or statutes of the respective States. For example, the consent has no effect upon the rights of an officer of the Federal Government to object that the imposition of a State tax upon him is invalid under the fourteenth amendment. Thus he may urge that a particular tax is invalid as to him because of an unreasonable classification, or the lack of geographical jurisdiction to tax, or for other reasons. Similarly, the consent has no effect upon the rights which such

> officers and employees possess as individuals under the various State constitutions and laws. To protect the Federal Government against the unlikely possibility of State and local taxation of compensation of Federal officers and employees which is aimed at, or threatens the efficient operation of, the Federal Government, the consent is expressly confined to taxation which does not discriminate against such officers or employees because of the source of their compensation. * * * ." [Emphasis added]

This language from the committee reports shows a congressional intent remarkably similar to the rationale which the Supreme Court enunciated the next month in the Graves opinion. Congress clearly intended to waive any constitutional intergovernmental tax immunity which might apply to individual federal employees, while preserving the right of those officers and employees as individuals to assert their own constitutional rights, such as objecting to a particular

tax because of an unreasonable classification under the Fourteenth Amendment. The statutory consent to taxation contained an exception for taxation which discriminates against the employees because of the source of the compensation and the congressional reports clearly demonstrate that this provision was intended to protect the federal government -- not the individual employee -- "against the unlikely possibility of state and local taxation of compensation of Federal officers and employees which is aimed at, or threatens the efficient operation of, the Federal Government ... ."

This expression of congressional intent dovetails very neatly with the rationale of Graves which, in summary, provides that the constitutional doctrine

of intergovernmental tax immunity cannot be employed to protect individuals as individuals, but only serves to protect the functions of a government itself from impermissible interference by the taxation efforts of another government. There is nothing in the language of 4 USC § 111, the legislative history, or decisions of this Court which indicates any congressional intent to permit an individual employee, such as Appellant Davis, to utilize the statute to assert on his own behalf the constitutional doctrine of intergovernmental tax immunity from Michigan's taxation efforts.

It must be recalled, of course, that Congress is free to enact the type of immunity statute which Appellant Davis seeks at any time, as the Court observed

in South Carolina v Baker, supra, 99 L Ed 2d at 607, n. 10:

> "The Federal Government, for example, possesses the power to enact statutes immunizing those with whom it deals from state taxation even if inter-governmental tax immunity doctrine would not otherwise confer an immunity."

C. The Michigan Income Tax Act Does Not Violate 4 USC § 111 With Respect To Appellant Davis Because The Federal Act Does Not Apply To Him Or, Alternatively, Any Discrimination Of Which He Is Entitled To Complain Is Justified By The Substantial Differences Between Federal Retirement Benefits And State Retirement Benefits.

1. Appellant Davis Is Not An Officer Or Employee Within The Meaning Of 4 USC § 111.

In 4 USC § 111 the United States consented to the taxation of "pay or compensation for personal service as an officer or employee ... if the taxation does not discriminate against the officer or employee because of the source of the

pay or compensation." Appellant Davis does not contend that he is an officer, but he does contend that he is an "employee" for the purposes of the section. The Michigan courts carefully considered this claim and rejected it. J.S. App. A4-A6. For federal civil service purposes an "employee" is defined at 5 USC § 8331(1)(A) and 5 USC § 2105. Clearly, Appellant Davis is not a current employee since he is no longer "engaged in the performance of a federal function". The Michigan courts correctly characterized his status as that of an annuitant which is defined in 5 USC § 8331(9) as a former employee. The word "employee" has been judicially interpreted to encompass only those who currently work for another for hire. See Allied Chemical & Alkali Workers of

America v Pittsburgh Plate Glass Co, 404 US 157 (1971); Lancellotti v Office of Personnel Management, 704 F2d 91, 95 (CA 3, 1983).

That federal definition of "employee" is consistent with the definition for Michigan income tax purposes contained in MCL 206.8 (which incorporates the internal revenue code definitions in 26 USC § 3401(c)) and in Michigan Administrative Code 1979, Rule 206.2, which provides that a relationship of employer and employee exists when the person for whom services are performed has the right to control and direct the individual who performs the service, not only as to the result to be accomplished by the work, but also as to the details and means by which that result is accomplished. In other words, an

employee is subject to the will and control of the employer, not only as to what shall be done, but also as to how it shall be done. In addition, the employer possesses the right to discharge the employee.

Appellant Davis and the amici curiae acknowledge the validity of these definitions of "employee" and do not contend that Davis is presently an employee, but they assert that these definitions are irrelevant because the first portion of 4 USC § 111 refers not just to compensation "of" an employee, but compensation for personal services "as" an employee. They then point to cases which refer to retirement benefits as deferred compensation. See Appellant's Brief, pages 15-17. This argument omits reference to the latter

portion of the statute which does not contain the language Appellant relies on and clearly contemplates current status as an employee (" ... if the taxation does not discriminate against the officer or employee because of the source of the pay or compensation"). In addition, the legislative history of the statute does not support Appellant's argument. In the House and Senate committee reports, no distinction is made between taxation "of" the compensation of employees and taxation of compensation for personal service "as" an employee. The following language is contained in both the House report, supra, at page 4 and the Senate report, supra, at page 11:

> "In order to facilitate reciprocal taxation as between State and Federal Governments, your committee believes that the United States should expressly consent to the taxation of the compensation of its officers and employees. Section 3 of the bill

> therefore provides that the United States consents to the taxation of compensation received after December 31, 1938, for personal service as an officer or employee of the United States... ." [Emphasis added]

Appellant Davis is not currently an employee and therefore Appellee State of Michigan submits that he is not within the scope of any protection afforded by 4 USC § 111.

2. 4 USC § 111 Prohibits Discrimination Against Governments, Not Individual Employees.

As we have previously argued, (supra, pages 9-38) both the congressional history of 4 USC § 111 and this Court's rationale in Graves, supra, reveal that only governmental entities as entities are protected by the constitutional doctrine of intergovernmental tax immunity and by the language of 4 USC

§ 111 which prohibits discrimination against employees because of the source of their compensation. Both the House and Senate reports clearly indicated that the statutory language was only intended for a limited purpose:

> "To protect the Federal Government against the unlikely possibility of State and local taxation of Federal officers and employees which is aimed at, or threatens the efficient operation of, the Federal Government ... ."

Likewise, the rationale of Graves, supra, indicates that the constitutional doctrine was not intended to protect employees, but only to protect governments themselves, Graves, supra, 306 US at 483-484:

> "As applied to the taxation of salaries of the employees of one government, the purpose of the immunity was not to confer benefits on the employees by relieving them from contributing their share of the financial support of the other government, whose benefits they enjoy, or to give an advantage to

> that government by enabling it to engage employees at salaries lower than those paid for like services by other employers, public or private, but to prevent undue interference with the one government by imposing on it the tax burdens of the other." [Footnote omitted]

In the instant case if there is discrimination in the effects of the Michigan Income Tax Act, the discrimination applies only to Appellant Davis and has no impermissible impact upon the federal government. Graves recognized that the constitutional immunity must be "narrowly restricted" 306 US at 483, and stated that the immunity cannot simply be implied, because even though some of the burden on an employee may be passed on to his or her governmental employer, any such burden, "is but the normal incident of the organization within the same territory of two governments, each

possessing the taxing power. The burden ... is one which the constitution presupposes ... ."

Although Graves, supra, dealt with questions of economic burden and the instant case deals with a question of discrimination, the court's discussion of the rationale for the constitutional doctrine of intergovernmental tax immunity remains the same in both instances. In Graves the Court held that even though an employee suffered an economic burden by state taxation, the constitutional doctrine did not permit imputing that burden to the federal government employer by implication. Here, Appellant Davis alleges that he suffers discrimination, but Appellee State of Michigan submits that the Graves rationale prohibits imputing any effect

of such discrimination to the government employer by implication. In the instant case there is nothing in the record to demonstrate "undue interference with the one government by imposing on it the tax burdens of the other" (Graves, supra, 306 US at 484) or to demonstrate that the Michigan Income Tax Act "is aimed at or threatens the efficient operation of, the federal government" (House report, supra, page 5; Senate report, supra, page 12).

In summary Appellee State of Michigan submits that neither the constitutional doctrine of intergovernmental tax immunity nor the statutory protections of 4 USC § 111 protect Appellant Davis as an individual from the burdens of the Michigan Income Tax Act. The constitutional doctrine cannot be implied and so Appellant Davis bears the burden of

demonstrating by facts in the record that the Michigan Income Tax Act is aimed at or threatens the efficient operation of the federal government or that the consequences as to him are so severe as to result in undue interference with the federal government. There are no facts in this record to demonstrate such effects and the allegations of potential harm to the United States contained on pages 1-2 of the amicus curiae brief of the United States are, just as they were in Graves, supra, 306 US at 485, too "speculative in character and measurement and too unsubstantial to form the basis of an implied constitutional immunity from taxation."

3. Even If Appellant Davis Is Entitled To Complain Of Discrimination In This Case, It Is Justified By The Substantial Differences Between Federal Retirement Systems And Public Retirement Systems In Michigan.

It is undisputed that benefits received from Michigan public retirement systems enjoy a tax exemption which is not available to most other retirement benefits, including benefits from federal retirees such as Appellant Davis. The Michigan courts analyzed this difference in treatment under traditional equal protection principles in order to determine whether the distinctions "bear a rational relationship to a legitimate state end", Jurisdictional Statement App. A6-A7. A similar traditional equal protection analysis was used in Grauvogel v Commissioner of Internal Revenue, 768 F2d 1087 (CA 9, 1985), where the court

upheld a federal statute granting tax-free status to a cost-of-living allowance given only to federal employees working in Alaska where Alaskan state employees were not given similar tax-free status. Appellee State of Michigan submits that this is the appropriate analytical standard to be employed in this case.

Appellant Davis and the amici curiae which support him, however, assert that the constitutional doctrine of intergovernmental tax immunity is implicated and that therefore a more difficult standard must be met in order to justify the distinctions. In Phillips Chemical Co v Dumas Independent School District, 361 US 376, 383 (1960), this Court said that if the constitutional doctrine is applicable, distinctions "must be

justified by significant differences between the two classes."

In the instant case Appellee State of Michigan submits that the "rational relationship to a legitimate state end" test rather than the "significant differences" test should be employed because the constitutional doctrine of intergovernmental tax immunity is not applicable, but in any event, Michigan submits that there are significant differences between the Michigan public retirement systems and the federal retirement systems which justify the different tax treatment under either standard.

The Michigan Court of Appeals concluded that "the attracting and retaining of qualified employees is a legitimate state objective which is rationally achieved by a retirement plan

offering economic inducements." J. S. App. A7. Neither Appellant Davis nor the amici curiae which support him appear to dispute this conclusion. Thus, if a traditional equal protection analysis is employed, the distinction between Michigan public employment retirement system benefits and all other retirement benefits (including federal retirement benefits) is legitimate and constitutional.

In addition to that justification, however, there are significant differences between federal retirement benefits and Michigan public employment retirement benefits which support different treatment.[1] Federal retirement benefits are significantly more generous

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[1]It should be noted that since Appellant Davis retired there have been changes to both the federal retirement system, see 5 USC § 8401 et seq, and to the Michigan public employment systems

than Michigan public employment retirement benefits in several respects. First, in order for a state employee to have a pension "vested", ten years of service is required, MCL 38.19, as opposed to five years of service for federal retirees, 5 USC § 8333. Second, the amount of pension benefits is based upon average final compensation and during the times at issue, Michigan public employment retirement benefits

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(such as a 1987 change from using five years to using three years for determining final average compensation). In addition, there are differences between the retirement benefits of various groups of state and local retirees, depending on statutory provisions and collective bargaining agreements. The discussion in the text is based upon benefits available to retirees from the State's civil service system as of the date of Appellant Davis' retirement in 1980. This group most closely approximates Davis' situation.

required using a five-year average, MCL 38.1(r), while the federal retirement system utilized a three-year average, 5 USC § 8331. Third, the amount of pension benefits is dependent upon the multiplier which is applied to the average compensation (together with years of service) and for purposes of Michigan public employment retirement benefits a multiplier of 1.5% was used, MCL 38.20(1), while for federal retirement purposes a sliding scale of 1.5% to 2.5% was used, 5 USC § 8339. Fourth, federal retirees may have life insurance continued after retirement. This benefit is mandated by statute in the same amount as before retirement. The amount of life insurance is then gradually reduced to either 50% or 25% of its face value depending on the retiree's election, 5

USC § 8706. State retirees, on the other hand, may have life insurance continued at a benefit of 25% of the amount held immediately prior to the retirement date. This benefit is not guaranteed by statute, but merely provided by contract.

When viewed in their entirety, it is clear that there are substantial differences between the retirement systems of federal employees and Michigan public employees. The federal system is much more rewarding financially and the federal benefits are much more secure than the benefits provided by the state system. To the extent that Michigan public employment systems are in competition with the federal government in seeking to hire and retain competent employees, Michigan public employment systems are at a significant disadvantage

when their retirement benefits are compared with federal retirement benefits.

This favorable treatment enjoyed by federal retirees is not a new development in the law. Even when the predecessor to 4 USC § 111 was in the process of enactment, it was recognized that federal employees enjoyed benefits greater than those of state and local government employees. In the Senate report from the Committee on Finance on the Public Salary Tax Act of 1939, supra, page 4, the committee discussed the economic impact of the proposed legislation and recognized that, on the average, federal salaries were generally higher than those paid by state and local governments:

> " ... Federal salaries in the low and middle salary range group are generally higher than those paid by State and local governments. It is believed that these employees should share in the cost of their State and local governments to the same extent as private employees."

The favorable treatment federal employees enjoy has continued from 1939 until the present day. The current substantial differences between federal retirement benefits and Michigan public employment retirement benefits are sufficient to justify the different tax treatment such benefits receive.

II

ASSUMING THAT THE MICHIGAN INCOME TAX EXEMPTIONS ARE IMPERMISSIBLY UNDER-INCLUSIVE, THIS COURT SHOULD VACATE THE STATE COURT DECISION AND REMAND TO THE STATE COURTS FOR DETERMINATION OF THE PROPER REMEDY OR, ALTERNATIVELY, THIS COURT SHOULD EXPAND THE EXEMPTION TO COVER FEDERAL RETIREES SUCH AS APPELLANT DAVIS RATHER THAN NULLIFY THE EXEMPTION CURRENTLY AVAILABLE TO OTHER PUBLIC EMPLOYMENT SYSTEM RETIREES.

The Michigan Income Tax Act exempts retirement benefits for retirees from the armed forces of the United States and exempts retirement benefits received from public retirement systems of state and local governmental units, but does not exempt the retirement benefits of all federal retirees such as Appellant Davis. If this failure to include the retirement benefits of all federal retirees in the exemption from Michigan income tax violates either 4 USC § 111 or the constitutional principle of intergovern-

mental tax immunity, the question arises as to the appropriate remedy, both as to Appellant Davis and, possibly, to other similarly situated federal retirees. In his complaint and amended complaint Appellant Davis requested the following relief:

> "(A) Judge, determine and decree that the Michigan Income Tax Law, insofar as it purports to tax income from Federal Civil Service Retirement benefits, is invalid and unconstitutional.
>
> "(B) Enter judgment for the plaintiff against the defendant in the sum of $4,299.53 being the amount of Michigan Income Taxes paid by plaintiff, based on Federal Retirement benefits, for the years 1979-1984, inclusive, together with interest." Joint App. 10-11.

As amicus curiae United States says in their brief, page 19, note 12, the proper prospective remedy in the circumstances of this case is a mandate of equal treatment which may be accomplished

either by extending the statutory exemption to all federal retirees or by invalidating the exemption as to all other governmental retirees who currently receive the favored treatment. There is nothing in the record of this case to show which of these alternatives the State of Michigan would prefer to adopt, so if this Court finds the current statutory plan unconstitutional, the Appellees submit that the most appropriate remedy would be to reverse the judgment of the Michigan Court of Appeals and declare that equality of treatment is mandated and then remand to the state courts for further proceedings, leaving it to the Michigan courts or the Michigan legislature to determine whether the discriminatory statutory exemption should be extended to Appellant and all

other federal retirees or withdrawn from all governmental retirees currently receiving the exemption.

A. If Appellant Davis' Federal Rights Have Been Violated, The Appropriate Remedy Would Be To Award Him A Refund.

Amicus curiae United States asserts, brief page 19, note 12, that with respect to Appellant Davis' claim for a refund, Michigan's "only option appears to be to give appellant a refund of any taxes he has paid on his federal pension" and cites Phillips Chemical Co v Dumas Independent School District, 361 US 376 (1960), and Moses Lake Homes, Inc v Grant County, 365 US 744 (1961), for the proposition that "a discriminatory tax is void and 'may not be exacted'". Unlike the instant case which seeks a refund and interest for taxes already paid, however,

neither Phillips nor Moses Lake Homes involved a request for a refund. Phillips was an action to enjoin collection of a tax and Moses Lake Homes began as a condemnation action and an injunction against proceeding with a tax sale. In both cases no taxes had been paid and only a prospective decree was sought to declare the taxes invalid. To say that a tax is invalid and may not be exacted in the future is not the same as saying that taxes which have already been paid must be refunded with interest. However, in Iowa-Des Moines National Bank v Bennett, 284 US 239 (1931), the Court did order a refund to a taxpayer who had been discriminated against in violation of federal law when it was taxed more heavily than its competitors. The Court observed that equality of treatment could

be achieved if the state either increased the competitors' taxes or decreased the petitioner's, but noted that petitioner should not be required to assume the burden of seeking an increase of the taxes which the others should have paid. 284 US at 247.

Michigan law permits refunds of taxes with interest, MCL 205.30, and so, consistent with Iowa-Des Moines National Bank, if the failure to include Davis' retirement benefits in the exemption from Michigan income tax violates his federal rights, it would be appropriate to award him the refund he seeks.

B. If The Michigan Income Tax Act Violates The Federal Rights Of Others Who Are Similarly Situated, This Court Should Vacate The Michigan Judgment And Remand The Case To The State Courts For Further Proceedings.

Even assuming this remedy is appropriate for Appellant Davis, however,

it is not necessarily appropriate for all others who may be similarly situated. Even in Iowa-Des Moines National Bank where the court recognized the inappropriateness of compelling the taxpayer to assume the burden of seeking an increase of the taxes of others, it also recognized that the federal right which is at issue is not a protection against overassessment of taxes; rather it is a right to equality of treatment, 284 US at 247:

> "The right invoked is that to equal treatment; and such treatment will be attained if either their competitors' taxes are increased or their own reduced."

This recognition of two remedial alternatives was articulated with particular clarity by Mr. Justice Harlan's opinion concurring in the result in Welsh v United States, 398 US 333,

344-367 (1970), where a majority of the Court reversed a conviction under the Universal Military Training and Service Act because of an underinclusive definition of what constituted a "religious" basis for conscientious objector status. The rationale of the plurality opinion of four Justices was that conscientious objector status could be given to the petitioner in Welsh by simple judicial construction of the language of the statute. Justice Harlan, however, believed that the plurality's opinion exceeded the limits of the doctrine of judicial construction of statutes and that it was therefore necessary to determine whether the statute's limitation of conscientious objector status to those whose beliefs were "religious" violated the First Amendment. He believed that

the statute was unconstitutionally underinclusive since it did not permit conscientious objector status based upon strongly held moral or ethical beliefs. The alternatives, then, were to declare the statute unconstitutional for failure to extend its benefits to non-religious beliefs or to extend the coverage of the statute to those who had been wrongfully excluded. It should be noted that Justice Harlan's opinion expressed only his own views, but the Court has subsequently cited the opinion favorably in both majority and unanimous opinions of the Court. See Califano v Westcott, 443 US 76, 89 (1979) and Heckler v Mathews, 465 US 728, 738-739 (1984). Appellees submit that the rationale expressed in Justice Harlan's opinion in Welsh is applicable to the instant case.

The core of Justice Harlan's rationale is found in this often-quoted paragraph, Welsh, supra, 398 US at 361:

> "Where a statute is defective because of underinclusion there exists two remedial alternatives: a court may either declare it a nullity and order that its benefits not extend to the class that the legislature intended to benefit, or it may extend the coverage of the statute to include those who are aggrieved by the exclusion."

Justice Harlan recognized that applying the benefits of a statute to a group not explicitly encompassed in the language of the statute involves something more than mere traditional judicial construction, Welsh, supra, 398 US at 355-356:

> "If an important congressional policy is to be perpetuated by recasting unconstitutional legislation, as the prevailing opinion has done here, the analytically sound approach is to accept responsibility for this decision. Its justification cannot be by resort to legislative intent, as that term is usually employed, but by a different kind of legislative intent, namely the presumed grant of power to the courts to decide whether it more

> nearly accords with Congress' wishes to eliminate its policy altogether or extend it in order to render what Congress plainly did intend, constitutional."

Before turning to an application of this principle in the instant case, it is important to recall that in Welsh the Court was interpreting a federal statute, and in the instant case, a state statute is involved. Justice Harlan extended the coverage of the federal statute in Welsh, albeit with some misgivings, but he also recognized " ... the more limited discretion this Court enjoys to extend a policy for the States even as a constitutional remedy." Welsh, supra, 398 US at 362, n. 15. Defendants-Appellees submit that in the instant case there are strong policy reasons why this Court should not embark on this analysis, but should instead vacate the judgment of the

Michigan Court of Appeals and remand this case to the state courts in order that the Michigan courts or the Michigan legislature be given an opportunity to determine whether the discriminatory statutory exemption should be extended to Appellant and other federal retirees or should be withdrawn from all other governmental retirees who currently receive the favored treatment.

In Skinner v Oklahoma, 316 US 535 (1942), the Court recognized the alternative course of extending a statute to cover an excluded class or not applying it to the wrongfully included group, but under the circumstances of that case, the Court declined to speculate which alternative the state would prefer to adopt and simply reversed the judgment. A similar result, in a less stark factual

context, was reached in Dorchy v Kansas, 264 US 286 (1924). In that case one section of a state labor statute was challenged on constitutional grounds but instead of reaching the merits of the constitutionality of the section, the Court chose to vacate the state court judgment and remand to the state courts to determine if the section had already been invalidated as a result of an earlier decision by this Court invalidating another portion of the same statute. In language appropriate to the instant case, the Court concluded that, in the absence of guidance from the state court, it was inappropriate to determine the question of severability, 264 US at 290-291:

> " *** Whether § 19 is so interwoven with the system held invalid that the section cannot stand alone, is a question of interpretation and of legislative intent. ***

> "The task of determining the intention of the state legislature in this respect, like the usual function of interpreting a state statute, rests primarily upon the state court. Its decision as to the severability of a provision is conclusive upon this Court. *** In cases coming from the state courts, this Court, in the absence of a controlling state decision, may, in passing upon the claim under the federal law, decide, also, the question of severability. But it is not obliged to do so. The situation may be such as to make it appropriate to leave the determination of the question to the state court. We think that course should be followed in this case.
>
> " *** So far as appears, the state court has not passed upon the question whether § 19, being an intimate part of the system of compulsory arbitration held to be invalid, falls with it. In order that the state court may pass upon this question, its judgment in this case, ... should be vacated."

In the instant case the Michigan statutory system provides exemptions for retirement benefits from public retirement systems within Michigan, from retirement benefits received from public

retirement systems of other states or political subdivisions which have reciprocity for similar Michigan benefits, and for retirement benefits received from the armed forces of the United States. This system dates at least since 1969 when the exemptions were enacted, and there is nothing in the record of this case in the way of legislative history or Michigan judicial authority to indicate how the state would interpret these provisions if their validity is called into question because the statutory system fails to exclude retirement benefits of other federal retirees. Given the fact that significant state revenues and policies are involved and given the fact that it is "necessary to measure the intensity of commitment to the residual policy and

consider the degree of potential disruption of the statutory scheme that would occur by extension as opposed to abrogation", Welsh, supra, 398 US at 365, Appellees submit that in the circumstances of this case, it would be most appropriate for this Court simply to vacate the judgment of the Michigan Court of Appeals and remand to the state courts with a mandate of equality of treatment, leaving it to the state courts or state legislature to determine whether the statutory exemption should be extended or withdrawn.

C. If This Court Imposes A Remedy, It Should Extend The Michigan Tax Exemption To Those Whose Rights Are Violated Rather Than Nullifying The Exemption For Those Who Currently Receive It.

Given the importance of these factors, Appellees submit that it is likely

that Michigan would choose to extend the benefits to federal retirees such as Appellant Davis, rather than withdrawing the benefits from all other governmental retirees and therefore, should this Court choose to reach the question itself instead of remanding to the state courts, Appellees submit that this Court should extend the statutory tax exemption rather than withdrawing it. There are several factors which militate in favor of this conclusion.

First, as shown by the history of the Michigan statutory system, the pattern is one of expanding, rather than contracting, tax exemption for governmental retirees. These exemptions have existed for nearly two decades which demonstrates a significant measure of "intensity of commitment to the residual policy" of exemption for

retirement benefits of governmental employees.

Second, the "degree of potential disruption of the statutory scheme" which would occur by withdrawing the tax exemption for those who currently enjoy it would be severe. The exemptions represent a conscious legislative policy conferring a benefit on tens of thousands of government employees. This represents a legitimate and important governmental purpose which would be absolutely frustrated by a judicial decision withdrawing the exemption. In Heckler v Mathews, 465 US 728 (1984), this Court upheld a five-year extension of an invalid gender-based classification used in determining social security spousal benefits primarily because the court recognized the "legitimate and important

governmental purpose" and the hardship which would result to individuals who had planned their retirements in reasonable reliance on the prior law. In Heckler v Mathews, the Court had the benefit of extensive congressional findings which are absent in the instant case because neither the Michigan courts nor the Michigan legislature have yet had an opportunity to consider the consequences of a decision holding the tax exemption system invalid, but it cannot be doubted that the Michigan statutory system conferring tax exemption on the retirement benefits received from many public retirement systems would have a substantial negative impact upon tens of thousands of Michigan taxpayers as well as upon taxpayers in the several states with similar statutory provisions. Much

of the rationale used by the Court in Heckler v Mathews is therefore applicable in the instant case, 465 US at 748:

> "In short, particularly in the years immediately preceding retirement, individuals make spending, savings, and investment decisions based on assumptions regarding the amount of income they expect to receive after they stop working. For such individuals reliance on the law in effect during those years may be critically important."

Just as in Heckler v Mathews, 465 US at 748, extending the tax exemption to a small additional group of federal retirees rather than withdrawing it from a large group of other governmental retirees would protect "people who are already retired, or close to retirement, from public employment and who cannot be expected to readjust their retirement plans to take account of" a sudden dramatic increase in their state tax

liability.

Third, in Califano v Westcott, supra, 443 US at 89-90, this Court recognized,

> "In previous cases involving equal protection challenges to under-inclusive federal benefits statutes this court has suggested that extension, rather than nullification, is the proper course."

While the instant case deals with arguments based on the principle of intergovernmental tax immunity, as well as traditional principles of equal protection, and concerns a state statute conferring tax benefits rather than a federal benefit statute, the situations are somewhat analogous and the same principle should apply. The Court in Califano v Westcott examined equitable considerations including the fact that nullification would have the effect of terminating benefits to many families

currently receiving them, 443 US at 92, and observed that, just as in the instant case, any negative financial consequences caused by extension of benefits would be absorbed by the government rather than the individuals who currently benefit from the exemption, 443 US at 93.

Fourth, Justice Harlan's opinion in Welsh put great importance upon the existence of a severability clause in the statute at issue in determining that the appropriate remedy was extension rather than nullification. Although the existence of a severability statute is not always dispositive, see Dorchy v Kansas, supra, Michigan law contains a severability provision very similar to that in Welsh and Appellees submit that Justice Harlan's rationale is applicable here. Michigan's severability clause provides:

MCL 8.5; MSA 2.216

"In the construction of the statutes of this state the following rules shall be observed, unless such construction would be inconsistent with the manifest intent of the legislature, that is to say:

"If any portion of an act or the application thereof to any person or circumstances shall be found to be invalid by a court, such invalidity shall not affect the remaining portions or applications of the act which can be given effect without the invalid portion or application, provided such remaining portions are not determined by the court to be inoperable, and to this end acts are declared to be severable."

This is very similar to the severability clause in Welsh, supra, 398 US at 364. Justice Harlan noted the "broad discretion conferred by a severability clause" and then examined the "intensity of commitment to the residual policy" and the "degree of potential disruption of the statutory scheme that would occur by extension as opposed to abrogation", 398

US at 365, and finally concluded that these considerations, when weighed in the context of the statutory policy, compelled the result that the statute should be extended rather than nullified, 398 US at 366:

> "When a policy has roots so deeply embedded in history, there is a compelling reason for a court to hazard the necessary statutory repairs if they can be made within the administrative framework of the statute and without impairing other legislative goals, even though they entail, not simply eliminating an offending section, but rather building upon it." [Footnote omitted]

Similarly in the instant case, the statutory policy of tax exemption for governmental retirement benefits has existed for two decades and more, and the "necessary statutory repairs" can be made "within the administrative framework of the statute and without impairing other legislative goals". The disruption to

the Michigan statutory system caused by extending tax exemption to some additional federal retirees is far less significant than the disruption which would occur by withdrawing the tax exemption for the many retired public employees who currently enjoy the tax exemption.

In summary, if the Michigan tax exemption system is found to be underinclusive in violation of federal law, Appellees submit that the most appropriate remedy would be for this Court to order a refund to Appellant Davis, vacate the judgment of the Michigan Court of Appeals and remand to the Michigan courts with a mandate of equal treatment in order to permit the Michigan courts or the Michigan legislature to determine whether the statutory

exemption should be extended or withdrawn. Alternatively, if this Court chooses to embark upon the determination whether the statutory exemption should be extended or withdrawn, Appellees submit that the exemption should be extended.

CONCLUSION

The judgment of the Michigan Court of Appeals should be affirmed.

Respectfully submitted,

FRANK J. KELLEY
Attorney General

Louis J. Caruso
Solicitor General
Counsel of Record
760 Law Building
525 West Ottawa Street
Lansing, Michigan 48913

Thomas L. Casey
Assistant Solicitor General
Richard R. Roesch
Ross H. Bishop
Assistant Attorneys General
Attorneys for Appellees